RICHARD RUSSELL'S DOW THEORY LETTERS, INC.
P. O. Box 1759, La Jolla, California 92038
Minimum of 26 Letters per year — $150 Annually
Registered with the Securities and Exchange Commission

November 22, 1978 LETTER 744

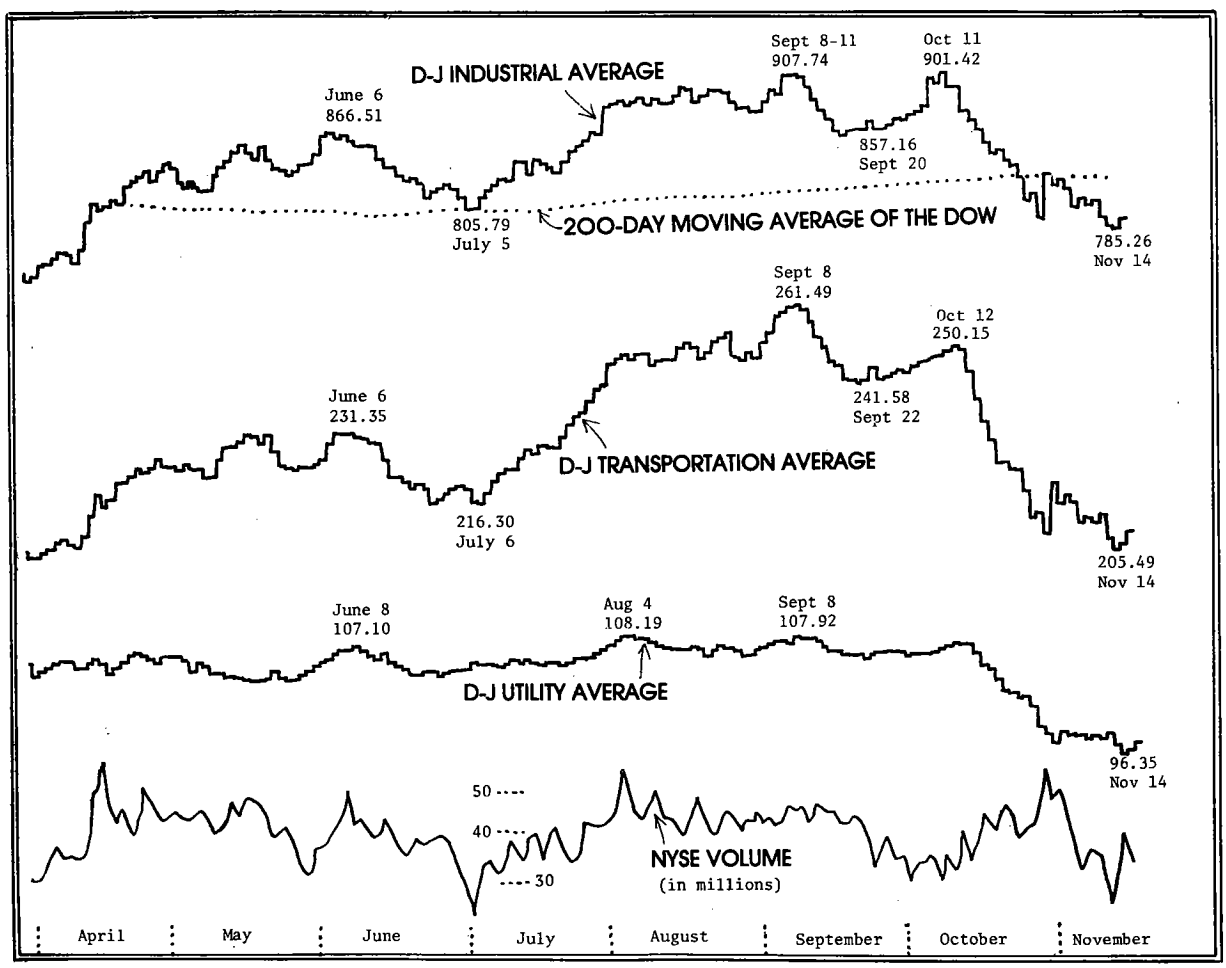
LIQUID: That is what I want all my subscribers to be–liquid. Which means in cash or equivalent, and that means 91-day Treasury bills. I discussed our move out of part or all of our gold in the last Letter, and I will go into more detail in this mailing. The whole country is now positioned and ready for inflation, more inflation and even hyper-inflation. But as I see it, the scenario coming up could well be deflation and depression. One reason I say that is because I believe that at least for a while, the dollar (fortified by rising interest rates) is going to be KING. In fact, I expect to see the dollar climb against just about everything–against stocks, bonds, currencies, gold, real estate, cars, you name it.

This nation is now margined to the hilt. Everyone is prepared for, and expecting endless inflation. Nobody has any use for the dollar. The dollar has been mocked, despised, laughed at. But with debt piled up everywhere, what we are facing is literally A GIANT SHORT POSITION AGAINST THE DOLLAR. This is the reason why–when we owe money (dollars), we repay with dollars. And if interest rates keep climbing, we are going to be pressured, pressured to repay. Thus the massive debt structure becomes a huge dollar short position in that a certain portion of this is callable. And that call is in dollars.

With the markets (almost all the markets) down, the losses are piling up, and these losses constitute dollars that are lost, dollars that have simply "evaporated." If the nation slides into depression, I believe there will be a tremendous demand for dollars, dollars that will be needed to stave off losses and bankruptcies. Thus, there is a subtle but very definite huge short position against the dollar, and I feel that the dollar's strength in the period ahead may surprise almost everybody. So–let's sit with our T-bills (which are dollars) and a little gold and watch events develop. At worst, we're going to be collecting attractive interest income on our T-bills, we'll be liquid, and we'll have peace of mind. We should also be ready to move into the various markets–when the time is right.

* *

On November 15, in a carefully worded and calculated statement, Alfred Kahn (Chairman, Council on Wage and Price Stability) told the press that if Carter's anti-inflation program fails, the alternatives are price controls or "a deep, deep depression." On November 16 President Carter stated that if his anti-inflation program does not work, the nation faces recession or "depression." What's happening? I believe that at least a few people in the Administration now recognize the writing on the wall. Mr. Carter and Mr. Kahn are hinting or telling the American people to get ready for hard times. This nation has been "over-consuming" for 33 years or ever since World War II. Now we must get ready to "under-consume." Americans have been living off burgeoning debt-creation for 33 years, and we're about at the end of the road. When the debt unwinds, the bear market will go into its third and final phase. We will enter that stage of the economy known as depression. I think we'll be in a depression starting in 1979.



Meanwhile, the Fed is on the firing line as never before. They must take a hard stand on the dollar, for if there is the slightest suspicion by currency traders that the Fed is "fudging it," the dollar is going to start sliding. It's going to be inflation or depression–the days and months of "in between" are fast drawing to a close!

THE PICTURE: There are a number of time-honored measurements of the market which have been used by analysts ever since the D-J Averages were first inaugurated. But perhaps the three most popular measurements are book value, price/earnings ratios and yields. By any or all of these measurements, the Dow is "cheap" today.

The estimated book value for the Dow is around 890. This means that the Dow is currently in one of those rare zones where it is actually selling below book. On the second count, the Dow is now selling at approximately 9 times earnings. In only 12 years since 1929 have the Dow P/E's dropped below 10, the area where they are now.

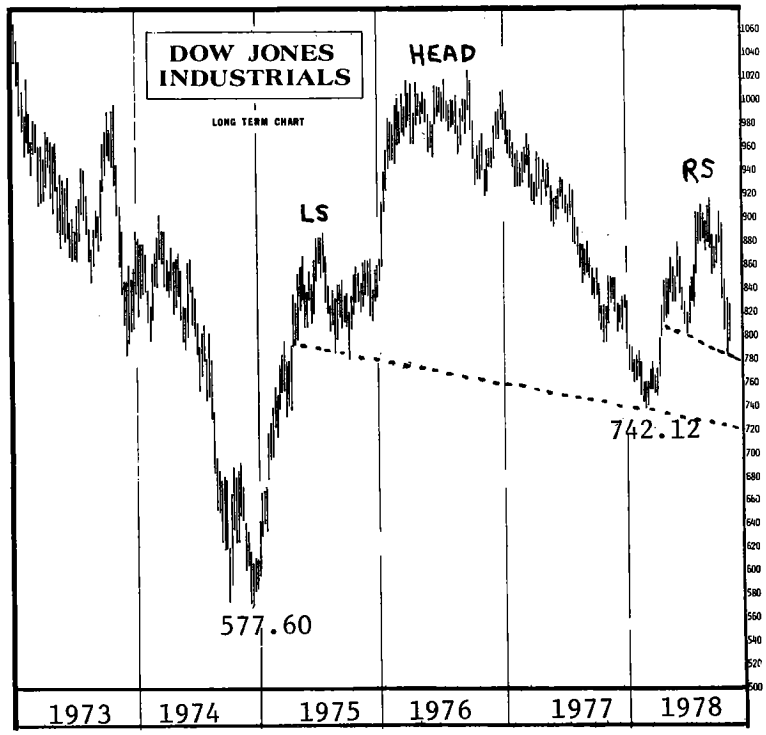
Finally, the yield on the Dow is now 5.90%, not far from the historically attractive 6% yield level. In the past, 6% on the Dow has always been considered the lower end of the "bargain in values" zone, an area which was seen during 1932, 1942, 1949 and 1953 (all major lows).

So my point is this–the Dow is now attractive from an historic valuation standpoint, there is just no question about that. But in view of these seemingly great values, I believe the action of the market itself is telling us that something is very wrong. In a phrase, *the market is looking somewhere else*. Ironically, I've read so much about "the great values in stocks today" that I think you can take a contrary opinion stance on the "great value" thesis. Can everybody be correct about the great values in the stock market and the wisdom of accumulating equities now?

If the market is indeed looking somewhere else, one wonders where the market is looking? The answer, I believe, is that the market is looking at the massive US debt picture, the interest rate spiral and the spector of deflation and depression. So I feel that the "great values" thesis is going to be the fooler, the trap that ensnares tens of thousands of hapless stockholders during the remainder of 1978 and during 1979.

In the last Letter I included my very long-term chart of the Dow along with the 13-year and 21-month moving averages. I wanted to show that the Dow was gradually rolling over, following its long climb since the 1940's. We now know that the giant margin debt on the NYSE is also rolling over. Following its almost uninterrupted climb since early-1975, the rate of margin build-up leveled off. And last week it was announced that margin debt dropped $300 million on the Big Board. This, to my mind, is the beginning of what should be an extended liquidation of the margin debt and a gradual destruction of the speculators. The margin run-off could last many months to over a year. There's simply no way of knowing, because we don't know how this third phase of the bear market is going to unwind.

I'm including above an arithmetic chart of the Dow, and this chart is worth studying carefully (chart courtesy of Heim Invest. Service, 729 SE Alder St., Portland, Ore. 97205). What we see here is a huge "head-and-shoulders" top, the most authoritative distribution pattern we have in technical analysis. I have labeled



the left shoulder (LS), the head, and the right shoulder (RS) on the chart.

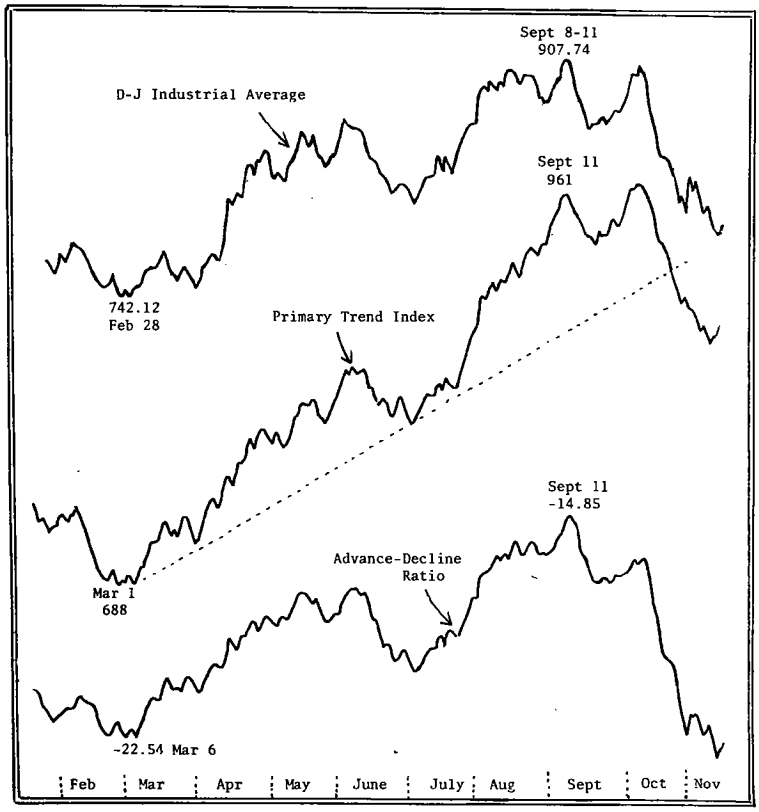
The right shoulder (February to September, 1978 rise) was a bear rally, an advance *against* the primary trend of the market (which is now bearish). When the primary trend is interrupted or held back, it usually resumes with increased force and violence. That, I believe, is what explains the violent breadth collapse of October-November.

Note now that the right shoulder itself is taking the form of a new and smaller head-and-shoulders top. If this newer formation is to construct a right shoulder, we might expect a Dow rally to say the 825-860 range. But such a rally would be a bull trap, and I therefore want my subscribers to ignore the rally. The primary trend is down, and both support levels on the Dow (the dotted lines on the chart) should be cracked in due time. This will mean an ultimate testing first of the 1978 low (Dow 742.12) and then the 1974 low of 577.60. I put the odds on the 1974 low holding at 50/50, but deep in my guts I fear that the 1974 low will be taken out by a liquidating and relentless market–probably sometime in 1979.

The November 16 WSJ published an article on the narrowness and illiquidity of the stock market. The article also noted that a shocking 47% of all NYSE margin debt reached the "under 40% of equity" level, a level where it is very vulnerable to call in case of a further market decline.

Turning to the page 3 chart of the Dow (daily) and the PTI and the A-D ratio, it is clear that the technical picture is deteriorating. The PTI is now in a major downtrend, having broken its 7-month rising trendline. Note how persistent the decline has been in the PTI and how meager (almost non-existent) the rallies have been. This is bear market action.

On November 14 the A-D ratio broke below its March 6 low (that was also the 1978 low). Thus, in a period of two months the market wiped out all the advancing action since March 6. The A-D rato is telling us that all stock portfolios purchased in 1978 are now "under water." This action again demonstrates the danger of "investing" against the primary trend of the market.



With the A-D ratio below its 1978 low, we have a non-confirmation between the Dow and the A-D ratio, and this should provide the technical strength for some kind of rally from this heavily oversold area. But the rally will be a bear rally—and that means we leave it alone.

GOLD AND DOLLARS: I've been keeping this chart for 9 years. It's the trade weighted dollar which shows the value of the dollar adjusted and weighted against 14 other currencies. I have made various notations on the chart, and these notations point out news events which occurred as the dollar rose or fell.

The dollar went into a long decline during 1970 to 1973. Between 1973 and 1975 the dollar traced out the triangle that you see on the chart. This building of strength in the dollar was discounted by gold when gold topped out in 1974 and declined to its 1976 low.

The dollar triangle broke to the upside during mid-1975 and the dollar remained strong until early 1977. Then we come to recent history and the sickening slide in the dollar to a low recorded a few weeks ago.

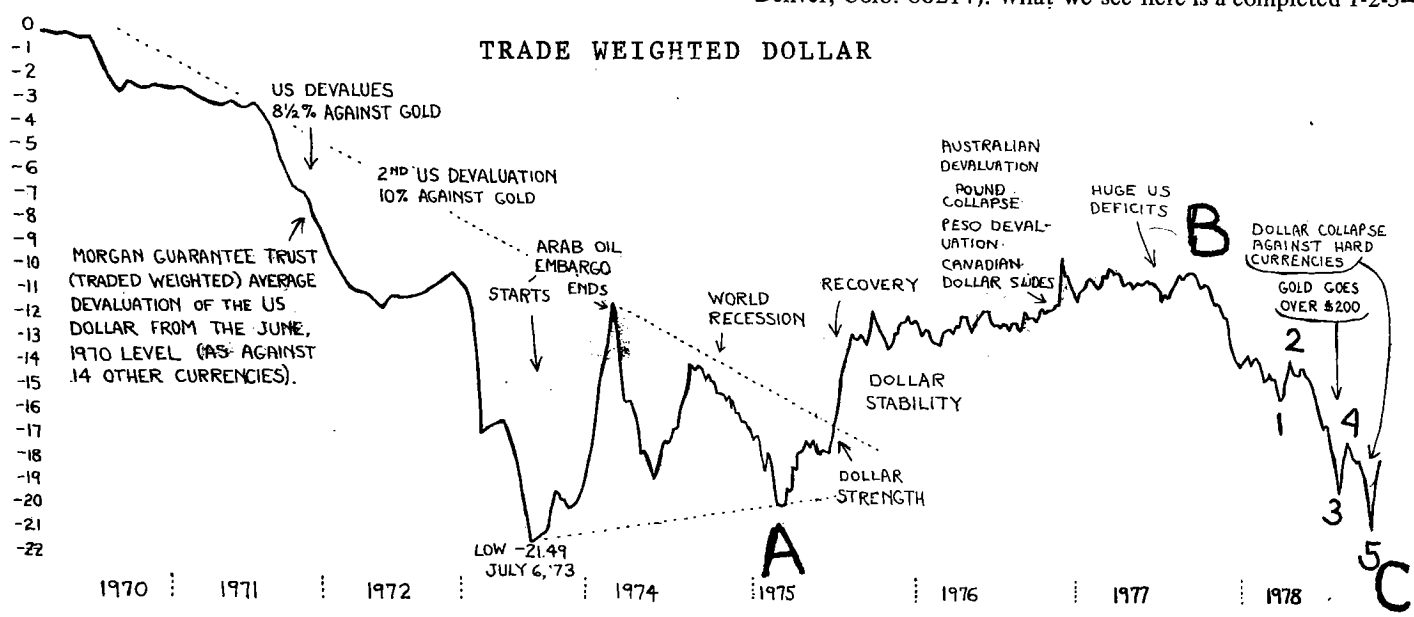
I have applied technical analysis to the trade weighted dollar, and the results are rather interesting. So far, what I believe we have is a giant A-B-C bear pattern in the dollar. The A leg carried down to 1975. The B leg rallied the dollar to mid-1977. And the C leg smashed to a low in November, 1978.

What interests me in particular is that the C leg has assumed the form of 5 sub-legs (numbered 1.2.3.4.5 on chart). The C leg has the *look of a major completed leg* to me. This is the reason why I believe we could have a stronger dollar and a more extended dollar advance than most skeptics on the dollar now think possible. I believe that the dollar is now in an important advancing leg. Whether this leg will carry above point B I do not know. Obviously if it does, the dollar will be in a major bull market. **If** the dollar halts its advance short of B, then turns down and breaks below C, I would say that we were seeing the next major decline in a continuing bear market for the dollar. But for now, dollar strength is the prevailing condition.

All of this has definite implications for gold. One of the reasons I turned cautious to negative on gold in the last Letter was the completed appearance of the C leg on this chart. As long as the new advancing leg is in force, I doubt that gold can muster any lasting strength. But if the current advancing leg is abbreviated, if it aborts, then gold will sense it and turn bullish.

The operative fact NOW is that the dollar has completed its C leg and is in a bullish trend. That tells us that holding dollars is now preferable to holding gold. A small amount of gold coins will still be a valid form of "insurance," but any holdings of gold should be **minimal** as outlined in the last Letter.

Many readers have never seen a chart of the currency futures, but here again we have a fascinating picture of sudden dollar strength and a completed "top out" move in one of the hard currencies. I show (page 4) the daily action of the Swiss franc via the March, 1979 future contract (chart courtesy of SMR, P.O. Box 14096, Denver, Colo. 80214). What we see here is a completed 1-2-3-4-5



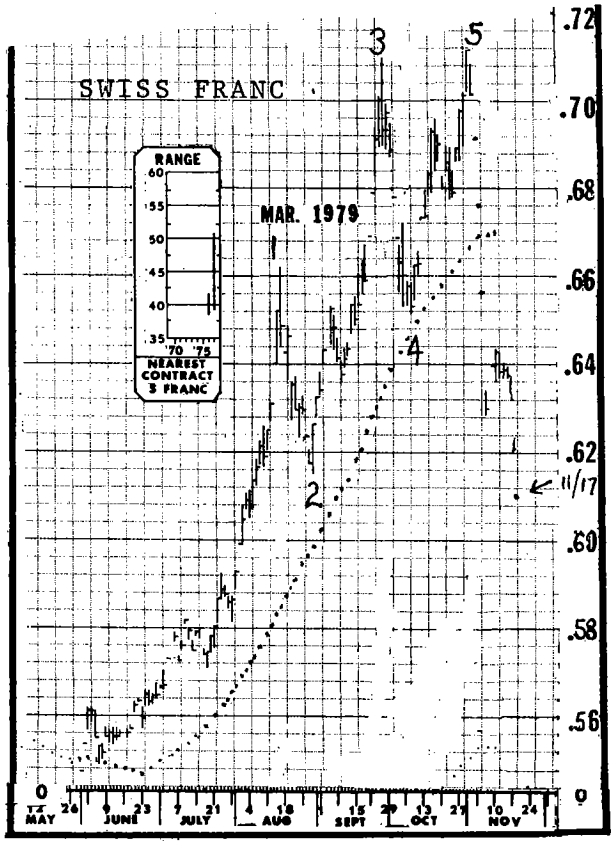
rising pattern, then a wild downside panic plunge (the dots on the chart are "limit down" moves), then a bit of support in the .63 to .64 range. Last week Swissy plunged down the limit again. Meanwhile, the 10-week moving average (dotted line) has rolled over and turned down, completing the violent top-out pattern for Swissy. The odds on Swissy moving back over the high any time in the near future are slim to zero.

Let's turn to gold again. One important item to note is that gold's momentum (the 13-week rate of change) hit a peak of 121 in October. By last week gold's momentum had dropped to 93.6 (in other words, gold was almost 6% below its price of 13 weeks ago). This plunge in gold's momentum is a negative sign.

It's negative because on the next rally it's certain that gold momentum will fall short of its previous peak. Therefore, even if gold were to rally back to its 243 high, my guess is that gold's momentum would be only 205 or so, and that always spells trouble. Therefore, the drop-off in momentum is telling us that gold has "made its move" for the time being.

I want to turn now to the ratio (semi-log) chart of gold below. This chart deals with percentages in that a rise from 10 to 20 on the chart will take up the exact same vertical distance as a rise from 50 to 100 or from 35 to 70 (all of these moves represent a 100% rise).

The chart shows gold climbing up a two-year rising channel. As long as gold held within this channel, it was clear that the metal was holding to a steady rate of growth. What I was afraid might happen did occur last week. On November 15 gold dropped below the bottom trendline of the channel. This tells me that the odds favor a severe, rather than a mild correction in gold.

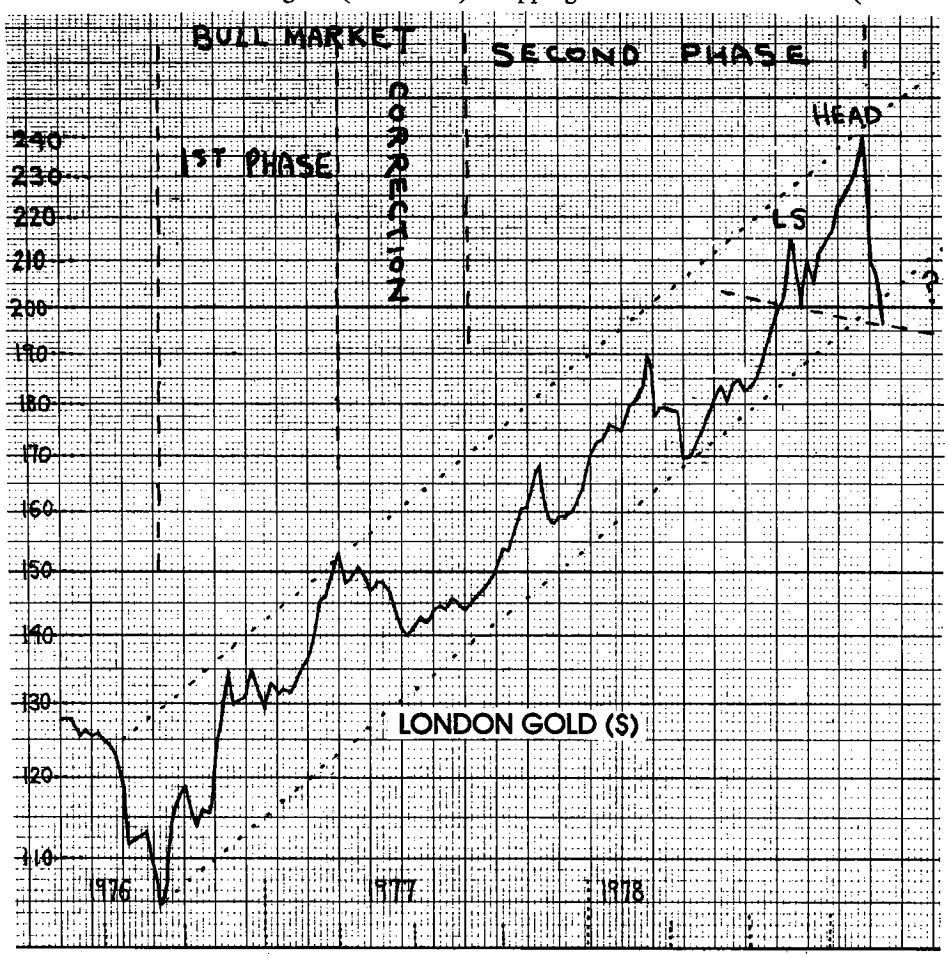


I have labeled the phases of the bull market in gold (so far). When gold hit 243 and then aborted (because of the record high in the discount rate), the second phase of the gold bull market ended. Second phase corrections tend to be severe and costly. It is during the second phase correction that I would expect gold to move from weaker to stronger hands. When gold finally bottoms out, following this correction, it should be in rock-strong hands, and it should then be ready for its third phase or final rise, but such a move could be months away, and we have to deal now with the corrective situation.

I said that I expected gold to trace out an A-B-C correction. So far, I would say that gold is in its first or A-leg down. It is a negative that the first leg ruptured the two-year rising trendline. The next rally in gold should be the B-leg. Unfortunately, I don't think the B leg will take gold very far into the channel again (if indeed it can rise within the rising channel at all). Following the B leg from wherever the B leg starts, we should get the final C leg down. I would guess, from what I see now, that the C leg could carry gold down to the 150 to 170 level.

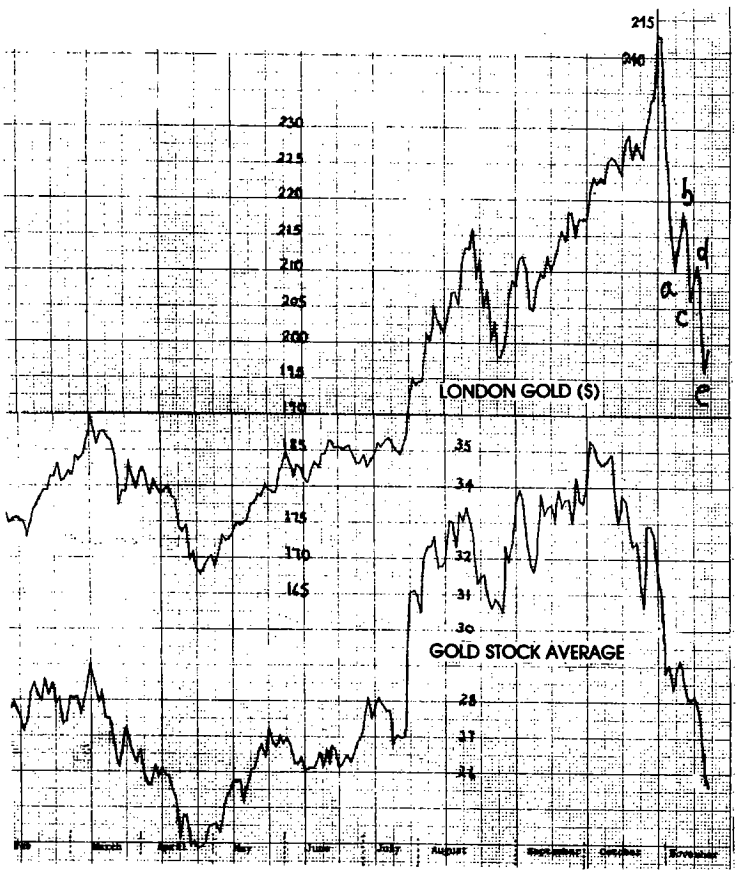
Note that gold has formed a potential head-and-shoulders top, and that any rally from here will give the pattern a right shoulder. This tells us that gold is under distribution and that the decline is not "a mistake" or "a Government plot."

On November 16 my tabulations show the 4-week moving average of gold (at 213.43) dropping **below** the 13-week MA (now at



214.14). This constitutes another technical sell signal for gold, and it suggests that the upside limit for any gold rally will be around the 214 or below area. The long-term or 50-week MA for gold is at 189. I feel that the correction could break temporarily below the 50-week MA.

My daily chart of gold and the gold stock average (GSA) shows gold finally confirming the GSA by breaking below its (gold's) August low of 197.50. However, note that gold has now taken the form of an a-b-c-d-e pattern down and this could end the first leg down. Therefore, gold should be ready to rally, and the strength of the rally back will tell us something important about the gold picture. If you have not lightened up on gold so far, any rally from here should give you the opportunity. I would cut down to a peak position of 15% of assets in gold. Meanwhile, from its 35¼ high, the GSA has lost about 26% of its value and is now only a point from its base of last August.



Question: Russell, you talk about a big bear market rally in the dollar. What makes you the dollar oracle? How do you *know* it's a bear market rally and not a major, new bull market in the dollar?

Answer: I don't know, but I operate on the principle that a trend continues in force until proved otherwise. Therefore, I will proceed on the basis of the dollar being in a bear market rally. If the dollar goes over its B point on my trade-weighted chart, then brother, we've got a bull market in the buck—but until then, I'm calling it a bear rally in the dollar.

Question: How big a rally could this bear rally be?

Answer: It could be very big. Don't forget, nobody believes the dollar can show real sustained strength; nobody is prepared for a dollar boom. But big bull moves tend to begin when all the experts think a bull advance is well nigh impossible. In other words, what intrigues me here about the dollar is that nobody believes it could be the strongest currency around—at least for a number of months! And nobody is positioned for such a move.

Question: What's behind the dollar strength?

Answer: Rising interest rates and dollar support by the Fed and by leading nations, but most of all the spector of deflation. The Administration has now committed itself to defending the dollar. Whether our foreign creditors gave the order makes no difference. A commitment has been made. I suspect, moreover, that the Carter people have decided to take a recession or even a depression. But I also suspect that Carter *believes* he can defend the dollar without having to face a severe recession. Carter's mistakes are (1) he should have made his moves the day after he was inaugurated, (2) he doesn't understand the bearish implications of the towering debt structure during a depression, (3) he thinks he can turn the economy up at will, and (4) he doesn't understand that markets are bigger and more powerful than the US Treasury, the Bank of England and all the governments of the Free World combined.

Remember, unemployment in the US is only 5.8% today, a low figure. In other words, nobody is hurting now, as far as the Administration is concerned. When unemployment climbs over 7% and the unions start screaming, then we will see how strong the Administration's resolve is.

Question: Won't interest rates come down sharply once business turns down? Why don't we move into long-term bonds now—in order to lock in some of those high (long-term) interest rates in say the Treasury bonds.

Answer: The Treasury bonds are acting a bit better now, even while the other bonds (corporates, utilities) are still declining. I have thought a lot about the bond situation, but I am not convinced that we should move out of T-bills and into long-term bonds at this point. For one thing, I keep an A-D ratio of all the bonds on the NYSE, and that ratio continues to move down. That's one of the technical reasons for my "bond-shy" attitude, but there's a fundamental reason that I've been thinking about—a reason that almost no one seems to see or comprehend.

Once deflation and depression set in, many bankruptcies will occur and many individuals and businesses will find themselves short of cash (cash needed to "keep them alive" and solvent). Remember, bankruptcies and market losses cause dollars and assets to disappear (for instance, over the last month over $100 billion in assets have disappeared in the stock market alone!) As assets and dollars evaporate, there could be a wild panic to raise or get hold of dollars. This panic could push short-term interest rates (temporarily) to new highs. Thus, the premium will be for cash, cash (dollars) at almost any price. Long-term bonds could hit new lows in such an environment.

Picture this: a financial panic is on, and many people and businesses are against the wall. You are sitting in Treasury bills. Are you going to be tempted to cash in your T-bills and lend the money out to banks or corporations? You bet you're not! And that's what can happen when everyone is "short" the dollar and the big squeeze and the big fear is on.

Question: Russell, how do commodities look here? Don't we have signs of inflation in the commodity markets?

Answer: The commodity markets have been murderous for most traders this year. A month ago many (most) of the com-

modities looked as if they "wanted to" break out in a big bull market run (see chart in Letter 741, page 4). But over the past few weeks most of the commodity charts have turned neutral to bearish. These unexpected and deceptive reversals have cost traders dearly. To my mind, this is all part of the gathering deflationary scenario.

Question: In the recent "Special Letter" you said to cut down to 15% in gold or (if you are a trader) get out altogether. Why did you pick the figure of 15% for those who want to hold some gold?

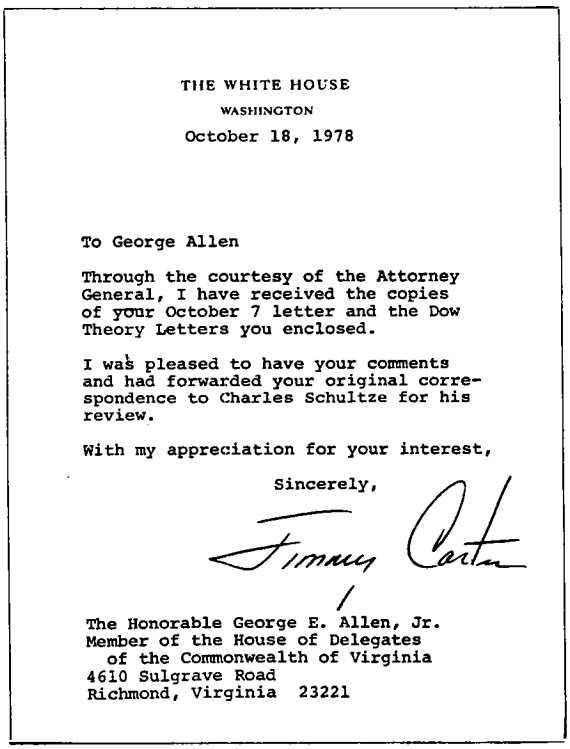
Answer: My work had turned bearish on gold. I knew from experience that many subscribers just don't want to sell all their gold, no matter how my charts look or no matter what I say. So I picked the lowest percentage figure that had any meaning. If a man has 15% of total assets in gold and gold drops to the 150-160 range, he has lost a third of his gold value, but a third of 15% is only 5%. I felt that 5% of assets was a reasonable paper loss to sustain if gold goes to 150-160. That's why I picked 15%.

Question: If you're convinced that only gold is real money, I can't see how or why you told us to cut back or eliminate gold. After all, if we go into a depression gold might go up.

Answer: There are a lot of "geniuses" around who will tell you that the country is going into "hyper-inflation" or "a slump" or "a depression." Theories (including mine) are cheap. But very few people can tell you **how an item is going to react** to a given set of circumstances. My belief is that this country is going into a deflationary depression. My charts told me that gold's reaction (at least its first reaction) to depression was going to be *down*. That's why I sent out the Special Letter.

Look, we pay the rent, we eat, we pay our utility bills with a form of purchasing power called dollars. I'm dealing with purchasing power in these Letters, not dreams or fantasies. If gold is going to lose some of its purchasing power over the next 3 to 6 months, I'm going to do my damnedest to direct my subscribers to safety and to the place where our purchasing power is most secure. In my opinion, that place right now is dollars. When I like gold again, I'll say so, and then we'll go back into it or boost our positions in it. But now, safety lies with the buck, and all our theories and wishes aren't going to change that.

LATE NOTES: This market is oversold on an "intermediate bottom" basis, but the big (final) bottom is far from here. I look for the third phase of the bear market to gather strength during early 1979 with perhaps a wide open panic or crash as the liquidation plus margin calls take hold. I don't know how much of a "year-end rally" this market will try to mount, but I don't believe it will be enough to warrant trading on the upside. However, one more big downside crack (if we get it) and I'll probably recommend covering GM and Avon puts and perhaps buying some "out of the money" calls for those who want to trade on an intermediate recovery. Many subscribers did buy the GM April 50's at around $1 or less, and these have better than doubled. Profits can be taken here with the possibility of buying back cheaper by year-end. Or for long-termers, hold the GM's until around March-April. They could easily be 5-10 by then.



THE WHITE HOUSE
WASHINGTON
October 18, 1978

To George Allen

Through the courtesy of the Attorney General, I have received the copies of your October 7 letter and the Dow Theory Letters you enclosed.

I was pleased to have your comments and had forwarded your original correspondence to Charles Schultze for his review.

With my appreciation for your interest,

Sincerely,

Jimmy Carter

The Honorable George E. Allen, Jr.
Member of the House of Delegates
of the Commonwealth of Virginia
4610 Sulgrave Road
Richmond, Virginia 23221

CRY THE BELOVED COUNTRY: I've been ranting and raving about Government profligacy, debt building and official greed and stupidity for a long, long time. But it's heartening to know that someone out there (besides my own, dear subscribers) is reading this stuff. . . . . .

NOTES & QUOTES: I would guess that Sears and GM receive as competent financial information as money can buy. In view of this, I was fascinated to read (a few weeks ago) that Sears had sold $550 million of its receivables to a group of banks. Then a week later GM slashed its 1978 year-end dividend from 1977's record $3.25 to $2.50. In both cases it's a matter of raising or conserving cash. Are the giants telling us something? I think so.

* *

Many people are asking where they should put the money they received from gold sales. My answer is T-bills, discussed earlier. For those who want the convenience of a money fund, I recommend a fund that is invested entirely in Government paper, and it is Capital Preservation of 459 Hamilton Ave., Palo Alto, CA 94301. Call from Calif. to 800-982-5844; from other states it's 800-227-8380.

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On November 17 Henry Kaufmann of Salomon Bros. predicted a recession in late-1979. He also predicted a prime rate well over 12% and high-grade bond yields at 10% to 11%. Kaufman is one of the most respected men on Wall Street, and few people write off his forecasts.

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My friend Ned Davis of J.C. Bradford & Co. thinks we are probably already in recession (based on retail sales figures which show no increase in unit sales over last year). He writes: "Because corporations will have to pay out some $115 billion in interest in 1978, a drop in sales will cause highly leveraged profits to plunge. Investors looking over the valley may be surprised at how deep it is."

NEXT MAILING: December 6th